This latest update of the Banco de España's macroeconomic projections for the Spanish economy includes the new information obtained since the last projections were published in December 2017.[1] The exercise includes, in particular, the Quarterly National Accounts data for the last quarter of 2017, and also information on the changes in the technical assumptions on which the projection exercise is based (see Table 1).[2]

The projections envisage a continuation of the current expansionary phase of the Spanish economy. This outlook is based, on one hand, on the gradual correction of the macrofinancial imbalances that built up in the expansionary cycle which preceded the crisis and in the more deeply recessionary stages of the crisis. This correction has given rise, in particular, to lower private sector debt, continued and sizeable external surpluses and the consequent moderation in net external borrowing, the gradual correction of the budget deficit, the fall in unemployment, which is however still too high, and the stabilisation and incipient recovery of the real estate sector. On the other hand, a number of more temporary factors also continue to support economic activity, such as the strength of the export markets, against a backdrop of ever more widespread global growth, and the expected expansionary stance of demand policies throughout the projection horizon. In particular, on the information available at this stage (which does not include the draft State Budget as it has still not been published), and following the neutral fiscal policy stance observed in 2017, a return to a somewhat more expansionary stance is expected as from 2018.

GDP has grown at a rate of more than 3% in the last three years; it is estimated that it will grow at a somewhat lower rate over the projection horizon. On one hand, the outlook for the global economy points to a gradual loss of momentum of the external markets. On the other, the present rate of expansion of economic activity in the euro area makes it more likely that inflation will converge towards its medium-term target. This reduces the need for additional monetary policy measures, in a setting in which the measures adopted previously should have a progressively lower incremental impact on financial conditions, activity and prices. Moreover, as discussed below, household spending on consumer goods and services should continue to show the signs of moderation that first appeared in 2017. The short-term information suggests that GDP growth in 2018 Q1 may have remained at the level of 0.7% observed in the third and fourth quarters of 2017. The minor slowdown in activity that is expected in coming quarters would give GDP growth of 2.7% in 2018, 2.3% in 2019 and 2.1% in 2020 (see Table 2).

1 Macroeconomic projections for the Spanish economy (2017-2020): the Banco de España's contribution to the Eurosystem's December 2017 joint forecasting exercise.
2 The cut-off date for the assumptions underlying the December 2017 projections was 22 November. The cut-off date for preparation of the assumptions underlying this exercise is 9 March, except for those relating to Spain's export markets, for which the assumptions for the current exercise are taken from the March 2018 ECB staff macroeconomic projections for the euro area, whose cut-off date is 13 February. Lastly, the cut-off date for preparation of these projections is 13 March.

Table 1
INTERNATIONAL ENVIRONMENT AND MONETARY AND FINANCIAL CONDITIONS (a)

Annual rate of change, unless otherwise indicated

		March 2018 projections			Changes from the December 2017 projections (b)		
	2017	2018	2019	2020	2018	2019	2020
International environment							
World output	3.6	3.9	3.7	3.5	0.2	0.1	0.0
Spain's export markets	5.2	5.0	4.1	3.6	0.1	0.2	0.0
Oil price in dollars/barrel (level)	54.4	64.4	61.1	59.1	2.8	2.1	1.7
Monetary and financial conditions							
Dollar/euro exchange rate (level)	1.13	1.23	1.23	1.23	0.06	0.06	0.06
Nominal effective exchange rate against the non-euro area (c) (2000 = 100 and percentage differences)	117.0	125.0	125.0	125.0	3.2	3.2	3.2
Short-term interest rates (3-month Euribor) (d)	-0.3	-0.3	-0.1	0.4	0.0	0.1	0.2
Long-term interest rates (10-year bond yield) (d)	1.6	1.5	1.9	2.2	-0.2	-0.2	-0.3

SOURCES: ECB and Banco de España.

a Cut-off date for assumptions: 9 March 2018. Cut-off date for foreign markets assumptions: 13 February 2018. The figures expressed as levels are annual averages; the figures expressed as rates are calculated on the basis of the related annual averages.
b The differences are in rates for world output and export markets, in levels for oil prices and the dollar/euro exchange rate, in percentages for the nominal effective exchange rate and in percentage points for interest rates.
c A positive percentage change in the nominal effective exchange rate denotes an appreciation of the euro.
d For the projection period, the figures in the table are technical assumptions, prepared following the Eurosystem's methodology. These assumptions are based on futures market prices or on proxies thereof and should not be interpreted as a Eurosystem prediction as to the course of these variables.

The prolongation of the expansionary phase, on the back of increased capacity utilisation, will give rise to a gradual pick-up in the rate of growth of the underlying component of the CPI which, after climbing by 1.2% in 2018, is expected to accelerate to 1.9% in 2020. In the case of headline inflation, the projections point to an average annual rate of change of 1.2% in 2018, rising to 1.7% in 2020.

The main changes in the assumptions on which these projections are built in comparison with the December projections concern budgetary policy. In this respect, the recent agreement on public sector pay and employment between the Government and the main trade union organisations for the period 2018-2020[3] is particularly noteworthy. The agreement includes a fixed pay increase for public sector employees of 6% in cumulative terms in the period (1.75% in 2018, 2.25% in 2019 and 2% in 2020). It also establishes two additional tranches that are dependent on certain conditions being met; if these conditions are satisfied, the cumulative increase would be just under 9%.[4] As regards public sector employment, the agreement adds momentum in 2018 to the more dynamic hiring policy of the past two years.[5] In particular, it broadens the range of cases where up to 100% of general

3 See http://www.lamoncloa.gob.es/serviciosdeprensa/notasprensa/minhap/Paginas/2018/090318-funcionarios.aspx (available only in Spanish).

4 In particular, regarding the pay increase, the first variable tranche is tied to economic growth: if GDP grows by 2.5% or more in 2019 and 2020, the pay increase would be 2.5% in 2019 and 3% in 2020. If GDP grows by less than 2.5%, the pay increase would decline in proportion to the extent to which the figure falls short of 2.5%. The second variable tranche consists in adding a further 0.55 pp to the 2020 pay increase if the budgetary stability target is met.

5 See the agreement signed between the Government and the trade unions on 29 March 2017 (available only in Spanish). In this respect, see also the discussion in "General government employment over the past decade", *Economic Bulletin* 4/2017, Economic Notes, Banco de España.

Table 2
PROJECTIONS OF THE SPANISH ECONOMY'S MAIN MACRO MAGNITUDES (a)

Annual rate of change in volume terms and % of GDP

		March 2018 projections			Changes from the December 2017 projections		
	2017	2018	2019	2020	2018	2019	2020
GDP	3.1	2.7	2.3	2.1	0.3	0.2	0.1
Private consumption	2.4	2.1	1.6	1.6	0.3	0.2	0.2
Government consumption	1.6	1.4	1.2	1.2	0.5	0.5	0.5
Gross fixed capital formation	5.0	4.3	4.1	3.9	0.3	0.4	0.2
Investment in equipment	6.1	5.0	4.1	3.8	0.6	0.4	0.0
Investment in construction	4.6	4.0	4.4	4.3	0.1	0.1	0.2
Exports of goods and services	5.0	4.9	4.8	4.5	0.0	0.1	0.0
Imports of goods and services	4.7	4.2	4.5	4.3	0.1	0.3	0.5
National demand (contribution to growth)	2.8	2.4	2.1	1.9	0.4	0.3	0.1
Net external demand (contribution to growth)	0.3	0.3	0.2	0.2	-0.1	-0.1	-0.2
Nominal GDP	4.0	3.9	3.8	3.8	0.5	0.2	0.0
GDP deflator	1.0	1.2	1.5	1.7	0.2	0.0	0.0
Consumer price index (CPI)	2.0	1.2	1.4	1.7	-0.2	-0.1	0.0
CPI excluding energy and unprocessed food prices	1.1	1.2	1.7	1.9	0.0	0.1	0.1
Employment (full-time equivalents)	2.8	2.7	2.0	1.9	0.4	0.3	0.3
Unemployment rate (% of labour force). End-of-period data	16.5	14.2	12.6	11.0	0.1	0.4	0.3
Unemployment rate (% of labour force). Average data	17.2	15.1	13.3	11.6	0.2	0.1	0.1
Net lending (+) / net borrowing (–) of the nation (% of GDP)	1.9	1.8	1.8	1.7	-0.3	-0.3	-0.5
General government net lending (+) / net borrowing (–) (% of GDP)	-3.1	-2.5	-2.1	-1.7	0.1	0.1	0.1

SOURCES: Banco de España and INE.
Latest QNA figure: 2017 Q4.

a Projections cut-off date: 13 March 2018.

government staff vacancies may be filled (and adds some cases where the replacement rate may be even higher), and includes additional measures relating to working hours and temporary employment. The agreement includes certain conditional factors tied to compliance with the budgetary rules.

At the cut-off date for this exercise, the draft State and Social Security Budget for 2018 had not been submitted. Accordingly, as in December 2017, various technical assumptions have been used to estimate the expected trajectories of fiscal policy variables. It has been assumed, first, that the budget headings subject to greater scope for discretion – notably including, by virtue of their volume, procurement and public investment – will evolve in keeping with the nominal potential growth of the Spanish economy and the latest developments in budget outturn,[6] and second, that all other general government account items will evolve, in the absence of measures, in keeping with their usual determinants.[7]

In accordance with these assumptions and projections on fiscal policy variables, and with the output gap estimated on a consistent basis within the whole projection exercise, the fiscal policy stance is set to be slightly expansionary in 2018, compared with the neutral stance estimated for 2017.

As regards all the other assumptions, there are few new developments and their impact on activity and prices tend to cancel one another out. The main change, in terms of its effects on the projections, is the improved global economic outlook, which is reflected in the upward revision, by 0.3 percentage points in cumulative terms between 2018 and 2019, in the rate of growth of Spain's export markets. In addition, since the cut-off date for the previous projections, the euro exchange rate has appreciated further, by 3.3 pp in effective nominal terms and rather more markedly (by 5.4 pp) against the dollar. Oil prices in dollars have risen slightly more than expected, especially in the short term, hence the upward revision of 4.9% for 2018 (tempered to a great extent in euro terms by the appreciation of the currency) and the more modest downward revision for 2019 and 2020.

In accordance with the expectations implicit in the yield curves, since the cut-off date for the assumptions underlying the previous projections the expected trajectory for interbank market rates has moved up, while the expected trajectory for government debt yields has moved down. In any event, these are minor changes, with a negligible impact on the expected cost of lending to households and non-financial corporations.

On the impacts estimated drawing on historical evidence, the changes in the assumptions overall – including the fiscal policy assumptions – compared with the December projections would give rise to an upward revision of expected GDP growth of approximately 0.1 pp in each of the three years of the projection horizon. This is mainly attributable to the expansionary fiscal measures (in particular, the stronger growth expected in public sector pay and employment) and, to a lesser extent, to the improved situation of the external markets, factors which are restrained somewhat by the exchange rate appreciation.

This revision of the outlook for Spanish economic activity is slightly more extensive in the first years of the exercise than would be justified by automatic application of the effect of the new assumptions. Specifically, the upward revisions to GDP growth amount to 0.3 pp in 2018, 0.2 pp in 2019 and 0.1 pp in 2020. This reflects a combination of factors. First, the information on the opening months of 2018 points to a somewhat higher rate of growth in Q1 than was expected at the end of 2017, and this more favourable pattern is also being carried over into Q2. Second, the flow of data on the external environment of the Spanish economy received in the month that has elapsed since the cut-off date for the relevant assumptions has been more positive than expected at the time. Lastly, the baseline scenario includes a slight easing of the political tension in Catalonia, as a consequence of the decline in the level of uncertainty since December.

In terms of growth in consumer prices, the impact of the new assumptions is broadly neutral, since the upward effects deriving from the fiscal expansion are countered by the exchange rate appreciation and by the rather more moderate rate of growth of oil prices in 2019 and 2020. However, the information now available on the most recent period warrants a downward revision of 0.2 pp in the rate of change of CPI for 2018, essentially owing to the performance of the energy component in the last few months. The projections for 2019 and 2020 are virtually unchanged.

In the projection period, spending on consumer goods and services will continue to be underpinned by the strength of the job creation process, continuing favourable financial conditions and the improvement in recent years in the financial position of the sector, as a consequence of the reduction in indebtedness and the appreciation in both real and financial asset prices. However, it is estimated that the slowdown observed in this spending component in 2017 will continue. This is as a result of various factors. First, spending decisions on consumer durables, which had been put off during the years of the crisis and which households have gradually resumed in the recovery years,[8] are expected to peter out over the projection period. Second, it is estimated that households will start to rebuild their savings from

6 The projections also include possible costs associated with the public liability arising from court proceedings relating to toll motorway company insolvency proceedings, which the Government estimates as around €2 billion.

7 Specifically it has been assumed that public revenue will increase in keeping with its tax bases, which depend mainly on the macroeconomic environment. Similar assumptions have been made for expenditure items that offer less scope for discretion. This is the case of pensions (where developments are essentially determined by the revaluation formula established by law and population ageing), unemployment benefits (which depend mainly on the level of unemployment) and interest payments (affected by changes in public debt levels and interest rates).

8 J. González Mínguez and A. Urtasun (2015), "Consumption dynamics in Spain by product type", *Economic Bulletin,* September, Banco de España, pp. 29-37.

the low level estimated at the end of 2017 (just under 6% of disposable income, the lowest level since the start of 2008). Indeed, in 2017 households experienced a squeeze on their real income as a result of a temporary rebound in inflation that agents apparently recognised as such, since they responded by reducing both their real spending and their saving. The assumption underlying these projections is that households will tend to moderate their consumer spending, in favour of a certain degree of recovery in their saving rate.

Lastly, the projections assume a rise in interest rates which, per se, has a minor impact on household income as it affects interest paid and interest received alike. However, it also has a negative effect on consumption, given that borrowers generally have a higher marginal propensity to consume than creditors.

In the case of gross fixed capital formation, it is expected that the residential component will continue to post high rates of growth, albeit slightly lower than those observed in 2017, in a context in which the trend towards favourable mortgage terms (such as lower interest rates and longer repayment periods) seen in recent years looks to be starting to fade and net lending by households has fallen sharply. Business investment, for its part, will continue to be underpinned by the strength of demand and the increase in capacity utilisation, in a setting in which the high generation of internal funds and the availability of borrowed funds on favourable conditions will continue to ease the way for financing of business investment.

Over the projection period as a whole, exports should continue to grow at a faster pace than their destination markets, thanks to the competitiveness gains achieved since the crisis and which are expected to continue into coming years, albeit at a slower pace. In the near term, however, the rate of growth of export sales will be mitigated by the effects of the appreciation of the euro since early 2017. By components, it is estimated that tourism services will moderate somewhat following the exceptional performance in recent years, as some Spanish tourist destinations become overcrowded and alternative destinations in the Mediterranean basin start to recover. Imports, for their part, as in other recent projection exercises, are expected to grow at a slower pace than their historical relationship with final demand would warrant, as a result of the incipient import substitution process prompted by the competitiveness gains achieved.

As is commonly the case during the expansionary phases of the Spanish economy, employment growth is set to remain closely pegged to growth in economic activity. The rapid pace of job growth will push down the unemployment rate further, although it will remain well above pre-crisis levels, at around 11% at the end of the projection horizon. This high level of unemployment is one of the factors constraining wage growth, although wages are expected to pick up over the next three years as the slack in the labour market decreases. Given that a parallel rise in productivity is not anticipated, this will push up unit labour costs. However, the rise in ULCs will be less than the ECB projects for the euro area as a whole, so the increase will still be compatible with continuing competitiveness gains relative to the euro area.

The Spanish economy will maintain its net lending position vis-à-vis the rest of the world, although it will be a few tenths of a percent lower than estimated for 2017 (when it stood at 1.9% of GDP). In particular, the goods and services surplus will remain around 2.7%, driven by two opposing forces: improved net trade flows in real terms and the deterioration in terms of trade. However, the rising interest rates foreseen in the external assumptions point to a slight worsening of the income balance.

On the consumer prices front, current projections envisage core inflation accelerating gradually from its current low levels. Forecast GDP growth over the projection horizon outpaces the existing estimates of the rate of growth of potential output. Therefore, the positive output gap that emerged, on our estimates, at the end of 2017 will tend to widen over the next three years, which is likely to drive up domestic inflationary pressures. Profit margins are expected to stabilise after the cumulative gains made in recent years. After a sharp increase in 2017, on the back of rapidly rising prices of oil and other commodities, external inflationary pressures will tend to moderate at the start of the projection horizon, thanks to the recent appreciation of the euro. However, they are likely to pick up again further down the line, given the expected gradual increase in global inflationary pressures while the slack in the global economy is gradually absorbed. Consequently, the CPI is projected to rise by 1.2% this year, following a path largely determined by the energy component which, on current oil-price assumptions, is likely to head up over the coming months to reach a peak in the summer before subsequently slackening off. For the next two years, the CPI is forecast to rise by 1.4% in 2019 and 1.7% in 2020.

The risks to the baseline economic growth scenario are mainly on the upside in the near term, as ongoing revisions to the projections for the global economy suggest that its expansionary momentum may be underestimated. By contrast, towards the end of the projection horizon, the risks are likely to be on the downside. On the domestic front, current projections assume that the decline in political uncertainty regarding the situation in Catalonia observed since the December projections will continue going forward. However, a resurgence of tension cannot be ruled out, with the consequent negative impact on the economy, particularly in Catalonia itself. Moreover, some recent announcements suggest a possible easing of budgetary consolidation efforts, beyond those already included in the baseline scenario. Although this would have expansionary effects in the short term, over a longer horizon it would exacerbate the economy's vulnerability to adverse shocks, given the high level of public debt and the need to undertake significant public debt reduction over the medium term. In the opposite direction, the baseline scenario includes the assumption of a partial recovery in the household saving rate, particularly after the sharp drop in 2017. However, the upturn in this variable may be less pronounced, leading to faster household consumption growth, and thus higher GDP growth.

On the external front, the new grand coalition agreement in Germany could give rise to a more expansionary budgetary policy in that country, which in the near term could boost the rate of growth in the euro area as a whole. However, the tensions in financial markets seen in early February suggest that the process of monetary policy normalisation in the advanced economies, and especially in the United States, is not without its uncertainties. In particular, an unexpectedly severe intensification of inflationary pressures could trigger fresh bouts of abrupt price corrections in financial markets. In this connection, the recent adoption of fiscal expansion plans in the United States has heightened these risks, as it has taken place in an economy with a very high degree of capacity utilisation. Other causes of uncertainty include, first, the possibility that the decision by the United States to impose tariffs on imports of steel and aluminium may trigger a spiral of similar measures by the authorities in other countries, with the attendant adverse effects on world trade. Second, various sources of geopolitical tension persist, including in Europe the continuing lack of clarity about the shape the future relationship between the European Union and the United Kingdom will ultimately take and the uncertainty surrounding the formation of a government in Italy, following the outcome of the last election.

The risks to prices appear to be balanced. The downside risks described above for the global economy also represent downside risks for the external component of inflation. Moreover, as noted, the projections rely on the assumption that wages and prices will respond to the reduction in the degree of slack to a greater extent than they have done since the start of the expansionary phase – a hypothesis that may fail to materialise. Nevertheless, the existence of non-linear effects in the relationship between economic activity and prices cannot be ruled out, such that after a certain point is passed, the reduction in cyclical slack starts to have ever larger inflationary impacts. Furthermore, the synchronisation of strong global economic growth suggests possible upward pressures on commodity prices. However, in the specific case of oil, these pressures would be offset by the fact that they would make a larger number of unconventional oil sources economically viable.